80-1402

Office-Supreme Court, U.S.
FILED
FEB 17 1981
ALEXANDER L. STEVAS,
CLERK

NO.

in the

Supreme Court

of the

United States

OCTOBER TERM 1980

Frank Principe, Ann Principe and Frankie, Inc.,
Petitioners,

vs.

McDonald's Corporation, McDonald's System, Inc., and Franchise Realty Interstate Corporation,
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW*

I

WHETHER A CIRCUIT COURT'S REFUSAL TO FOLLOW THOSE TESTS ADHERED TO BY ALL CIRCUITS, HAVING CONSIDERED CLAIMS OF A FRANCHISOR'S ANTITRUST TYING VIOLATION, AND WHETHER THE CREATION OF A NEW TEST IN CONFLICT WITH THE STANDARDS OF SUCH OTHER CIRCUITS, JUSTIFIES ISSUANCE OF CERTIORARI BY THIS COURT ON GROUNDS OF CONFLICT AND IMPORTANCE.

II

WHETHER A CIRCUIT COURT'S REFUSAL TO FOLLOW ITS OWN APPLICABLE RULE REQUIRING A TRIAL DETERMINATION OF CONTESTED FACT ISSUES IS SO CONTRARY TO FUNDAMENTAL LAW AS TO WARRANT ISSUANCE OF CERTIORARI.

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*The parties hereto are all identified in the caption to this Petition.

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STATUTES:

§1, Sherman Act (United States Code, Title 15, §1) 1

STATEMENT OF JURISDICTIONAL GROUNDS

Petitioners seek review of the September 26, 1980, judgment of the United States Court of Appeals for the Fourth Circuit, in a matter in which petitioners herein were appellants and respondents herein were appellees. That decision was rendered by an order of said court denying appellants' petition for rehearing en banc, filed November 19, 1980.

Jurisdiction is conferred upon the Court under the United States Code, Title 28, §1254(1).

The decision under review is officially reported at *Principe v. McDonald's Corp.*, 631 F.2d 303 (4th Cir. 1980).

STATUTE INVOLVED

Section 1, Sherman Act (United States Code, Title 15, §1)

§1. Restraint of trade; resale price maintenance; penalty

Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal: Provided, That nothing herein contained shall render illegal, contracts or agreements prescribing minimum prices for the resale of a commodity which bears, or the label or container of which bears, the trade mark, brand, or name of the producer or distributor of such commodity and which is in free and open competition with commodities of the same general class produced or distributed by others, when contracts or agreements of that description are lawful as applied to intrastate transactions, under any statute, law, or public policy now or hereafter in effect in any State, Territory, or the District of Columbia in which such resale is to be made, or to which the commodity is to be transported for such resale, and the making of such contracts or agreements shall not be an unfair method of competition under section 5, as amended and supplemented, of the act entitled "An Act to create a Federal Trade Commission, to define its powers and duties, and for other purposes,"

approved September 26, 1914 [15 USC §45]: Provided further, That the preceding proviso shall not make lawful any contract or agreement, providing for the establishment or maintenance of minimum resale prices on any commodity herein involved, between manufacturers, or between producers, or between wholesalers, or between brokers, or between factors, or between retailers, or between persons, firms, or corporations in competition with each other. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding one million dollars if a corporation, or, if any other person, one hundred thousand dollars, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court. (July 2, 1890, c. 647, §1, 26 Stat. 209; Aug. 17, 1937, c. 690, Title VIII, 50 Stat. 693; July 7, 1955, c. 281, 69 Stat. 282; Dec. 21, 1974, P. L. 93-528, §3, 88 Stat. 1706.)

STATEMENT OF THE CASE

A. Proceedings Below

This is a claim of antitrust tying violation under §1 of the Sherman Act (United States Code, Title 15, §1), brought by franchisees of McDonald's System, Inc. ("McDonald's System"), charging, *inter alia*, an unlawful tie-in whereby the franchisee is required to lease his business premises from an affiliate of his franchisor.

The action was commenced in the United States District Court for the Eastern District of Virginia in June of 1978, with the filing of a complaint in several counts alleging multiple violations of state and federal antitrust laws. Plaintiffs therein were Frank Principe and his wife, Ann Principe, and Frankie, Inc., a family corporation owned by Frank Principe and his son, Ray Principe (hereinafter collectively referred to as the "Principes"). Plaintiffs, between them, operate McDonald's hamburger restaurants in Hopewell and Colonial Heights, Virginia, as franchisees.

Defendants in the action below were McDonald's Corporation and two of its wholly-owned subsidiaries, McDonald's System and Franchise Realty Interstate Corporation ("FRIC"). For convenience, all will be referred to collectively as "McDonald's," unless otherwise noted.

During the course of litigation in the district court, the claims were simplified to essentially two issues to be tried to the jury, one of which was the violation of state and federal antitrust laws through the requirement that all franchisees operating McDonald's restaurants

also lease those restaurant premises from a McDonald's subsidiary. At trial, the district court directed a verdict for defendants on that issue for the reasons that (a) plaintiffs had introduced "no evidence" of McDonald's economic power in the market for the tying product, and (b) plaintiffs had failed to adduce any credible evidence that there were two products, rather than one combination package as defendant had urged, and that there was not enough of a question to go to a jury. The remaining issue was resolved by the jury in favor of McDonald's.[1]

Judgment was entered July 30, 1979, and plaintiffs motion for a new trial was denied.

An appeal was taken to the United States Court of Appeals for the Fourth Circuit, which affirmed the district court's decision in its opinion of September 26, 1980, reported at 631 F.2d 303. The Principe's petition for rehearing and suggestion for rehearing en banc was denied by order of November 19, 1980.[2]

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[1]Several evidentiary and procedural errors with respect to that issue were raised on appeal, and were essentially ignored in the decision, 631 F.2d at 311. Those errors are not, however, here urged as grounds for certiorari.

[2]Copies of the referenced opinion and order are included in the appendix hereto.

B. Facts

1. The Franchise Relationship

In 1970, Frank and Ann Principe became McDonald's franchisees by executing a franchise license agreement with McDonald's System, authorizing use of the "McDonald's" name and method of doing business for a term of 20 years. At the same time, they became tenants of FRIC by executing a lease agreement covering the restaurant premises for a like term of 20 years. Each agreement provides that breach of it is breach of the other. As consideration for the license, the Principes paid a fee of $10,000, and undertook to pay 2.2 per cent of gross sales to McDonald's System, as licensor. Pursuant to the lease, an additional 8 per cent of gross sales is paid to FRIC as rent for the land and building. The franchise tenant pays all taxes, insurance, upkeep and renovation.

It was stipulated that McDonald's Corporation, McDonald's System, and FRIC are each separate corporations; that each engages in business activities in its own name, files its own tax returns, has its own books and records, and maintains its own funds; and that each of them has substantial and differing sources of revenue.

The Hopewell store cost FRIC approximately $188,500, including $52,500 paid to purchase the land. By 1978, however, the 8 per cent rent provision, when applied to the Principes' gross sales at Hopewell, generated rents of approximately $52,000 for just that year alone. Therefore, in one year FRIC virtually recouped

the original cost of buying the land. In less than four years at the current rate, McDonald's recovers all of its cost for the real estate, and all rentals for the remainder of the 20 year lease are pure profit.

In 1974, Frank and Ray Principe were offered an additional franchise at Colonial Heights on the condition that they become lessees of FRIC at that location. Similar instruments were accordingly executed. As they had done with Hopewell, plaintiffs asked if they could operate McDonald's restaurants on their own land. They were again told they could not. At Colonial Heights, however, FRIC was unable to purchase the property outright, but did control it through a lease with the owner. FRIC therefore subleased this improved property to the Principes.[3]

It was not controverted that the Principes, in order to obtain these licenses with McDonald's Systems, had to be tenants of FRIC.

2. Economic Power

McDonald's is the nation's leading fast food franchisor. At the time of trial, there were more than 4,700 McDonald's restaurants in the United States alone, of which some 3,500 were franchised. McDonald's

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[3]For a more detailed description of the mechanics by which McDonald's operates, see *Martino v. McDonald's System Inc.*, 81 F.R.D. 81 (N.D. Ill. 1979) at 84, 87-89; in the interest of brevity, that memorandum decision is here adopted by reference. The same case is further reported at 1980-1 T.C. ¶63,218 (N.D. Ill. 1980).

franchisees are not permitted to own their own restaurants, but must lease them from a McDonald's subsidiary. In fact, it was stipulated that the lease and license can only be had together, as a take-it-or-leave-it proposition. Franchisees therefore operate McDonald's restaurants which are owned by McDonald's (e.g., Hopewell) or controlled by it through a lease (e.g., Colonial Heights).

As stipulated, respondents and their franchisees, as a group, are the leaders in the fast food industry in terms of dollar sales volume. In addition, the average McDonald's restaurant has a higher average sales volume than the average for others in the business, such as Hardees, Burger King, Burger Chef, Kentucky Fried Chicken, and other similar fast food chains. In fact, in the fast food business, no one else is comparable; the chief accounting officer for McDonald's testified, "We are the number one. According to the restaurant industry, we are the largest and we do the most volume as a system." In his view, a McDonald's franchise was more economically desirable than any other, and he expects that McDonald's will retain its title as biggest in the business.

When asked what was unique about a McDonald's franchise, its board chairman, Fred Turner, testified that, "It's the food service success story of the Twentieth Century, if not the world history of mankind, although I'm not sure how the Roman legions were fed."

As further evidence of its awesome dimensions, McDonald's opened new restaurants in 1978, alone, having a development cost of more than a quarter of a billion dollars; for 1978, McDonald's reported system-

wide sales of approximately $4.5 billion and listed assets of $1.9 billion, including the land and buildings owned by FRIC, the leasing subsidiary.

Notwithstanding the decision of the district court, McDonald's did not list economic power as a disputed trial issue in the pretrial stipulation, and proof of that power was for that reason not emphasized at trial by plaintiffs.

The Fourth Circuit ignored the district court's determination that the Principes had failed to demonstrate economic power as a prerequisite to a tying claim.

3. The Franchise "Package"

In the court of appeals, McDonald's argued that requiring a franchisee to lease his restaurant from FRIC, as a condition to obtaining a license from McDonald's System, was necessary to McDonald's being able to maintain its superiority in the field of franchising. This argument was accepted by the court of appeals in a decision which turned on that single point, holding:

> "Where the challenged aggregation is an essential ingredient of the franchised system's formula for success, there is but a single product and no tie in exists as a matter of law."

ARGUMENT

I

WHETHER A CIRCUIT COURT'S REFUSAL TO FOLLOW THOSE TESTS ADHERED TO BY ALL OTHER CIRCUITS, HAVING CONSIDERED CLAIMS OF A FRANCHISOR'S ANTITRUST TYING VIOLATION, AND WHETHER THE CREATION OF A NEW TEST IN CONFLICT WITH THE STANDARDS OF SUCH OTHER CIRCUITS, JUSTIFIES ISSUANCE OF CERTIORARI BY THIS COURT ON GROUNDS OF CONFLICT AND IMPORTANCE.

A. The Challenged Decision

The essential holding of *Principe v. McDonald's Corp.*, 631 F.2d 303 (4th Cir. 1980), is as follows (at 309):

> "Where the challenged aggregation is an essential ingredient of the franchised system's formula for success there is but a single product and no tie in exists as a matter of law."

The logic of this holding mandates the conclusion that any seller who prepares a marketing formula, premised upon the condition that a second and more expensive product will be tied to the purchase of the first, will be free of prosecution under the antitrust laws, for a claim of tying violation, if he simply affirms that he cannot rise above the level of his competitors using any other business method.

It is clear that McDonald's is the undisputed leader and giant of the fast food industry — the "food service success story of the Twentieth Century." It is moreover both clear and essentially undisputed, as McDonald's argued to the Fourth Circuit, that it could not have attained this phenomenal success, nor could it continue to maintain its leadership in the industry, without total control over the restaurants which it requires its licensees to lease from the real estate subsidiary. McDonald's enormous economic power derives from the formula by which it leases restaurants for 20 years, pays for the restaurants in the first four, and clears a total profit on rental income for the remaining sixteen. The formula for success developed by McDonald's places it among the giants in the nation in real estate development; the actual selling of hamburgers is but a collateral aspect of that formula.

B. Conflict Among Decisions

For now, the impact of *Principe* has been limited to the geographic confines of the Fourth Circuit. The result is a conflict of Olympian proportions between this new rule and the rules which have been developed for use everywhere else — by this Court and by all of the courts of appeal which have considered tying claims brought pursuant to the antitrust laws. In the interest of brevity, the decisions of the several federal appellate

courts with which the case under review conflicts irreconcilably are set out in the margin, by footnote.[4] The facts and the legal analysis in each are different but not distinguishable. In every one of the decisions cited in the margin, this Court and the court of appeals for the several circuits concluded that the Sherman

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[4]*Supreme Court: International Salt Co. vs. U.S.*, 332 U.S. 392, 68 S.Ct. 12 (1947); *International Business Machines Corp. v. U.S.*, 298 U.S. 131, 56 S.Ct. 701 (1936); *Northern Pacific Ry. Co. v. U.S.*, 356 U.S. 1, 78 S.Ct. 514 (1958); *United States Steel Corp, v. Fortner Enterprises, Inc.*, 429 U.S. 610, 97 S.Ct. 861 (1977); *First Circuit: Dehydrating Process Co. v. A.O. Smith Corp.*, 292 F.2d 653 (1st Cir. 1961), *cert. den.* 368 U.S. 931, 82 S.Ct. 368 (1961); *Second Circuit: Susser v. Carvel Corp.*, 332 F.2d 515 (2nd Cir. 1964), *cert. dis.* (as improvidently granted) 381 U.S. 125, 85 S.Ct. 1364 (1965), and *Hill v. A-T-O, Inc.*, 535 F.2d 1349 (2nd Cir. 1976); *Third Circuit: Bogosian v. Gulf Oil Corp.*, 561 F.2d 434 (3rd Cir. 1977), *cert. den.* 434 U.S. 1086 (1978), and *Ungar v. Dunkin' Donuts of America, Inc.* 531 F.2d 1211 (3rd Cir. 1976), *cert. den.* 429 U.S. 823 (1976); *Fourth Circuit:* see cases cited in text; *Fifth Circuit: Boeing Co. v. Shipman*, 411 F.2d 365 (5th Cir. 1969) (as to standards for directed verdict); *Warriner Hermetics, Inc. v. Copeland Refrigeration Corp.*, 463 F.2d 1002 (5th Cir. 1972), *cert. den.* 409 U.S. 1086 (1972); *Carpa, Inc. v. Ward Foods, Inc.*, 536 F.2d 39 (5th Cir. 1976); *Heatransfer Corp., v. Volkswagenwerke A.G.*, 553 F.2d 964, *reh. den.* 562 F.2d 1257 (5th Cir. 1977), *cert. den.* 434 U.S. 1087 (1977); *Sixth Circuit: Ware v. Trailer Mart, Inc.*, 623 F.2d 1150 (6th Cir. 1980); *Seventh Circuit: Photovest v. Fotomat Corp.*, 606 F.2d 704 (7th Cir. 1979), *cert. den.* ___ U.S. ___, 100 S.Ct. 1278 (1980); *Eighth Circuit: Northern v. McGraw-Edison Co.*, 542 F.2d 1336 (8th Cir. 1976), *cert. den.* 429 U.S. 1097, *reh. den.* 430 U.S. 960 (1977); *Ninth Circuit: Siegel v. Chicken Delight, Inc.*, 448 F.2d 43 (9th cir. 1971), *cert. den.* 405 U.S. 955 (1972), and *Moore v. Jas. H. Matthews & Co.*, 550 F.2d 1207 (9th Cir. 1977).

Act is still law, and that the conditioning of the sale of one product upon the purchase of another is unlawful when certain conditions precedent are met.

As an illustration, in *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43 (9th Cir. 1971), *cert. den.* 405 U.S. 955 (1972), it was held, 448 F.2d at 49, as follows:

> "The relevant question is not whether the items are essential to the franchise, but whether it is essential to the franchise that the items be purchased from [franchisor]."

While the Fourth Circuit in *Principe* clearly stated that it intended a retreat from other aspects of the holding in *Chicken Delight*, the decision of *Principe* assumes the validity of the principle above quoted, and then proceeds to determine that the missing element of the franchisor's "need" either has been proven, or need not be proven but merely stated.

In *United States Steel Corp. v. Fortner Enterprises, Inc.*, 429 U.S. 610, 97 S.Ct. 861 (1977) (*Fortner II*), this Court reaffirmed just recently the *per se* rule as to tie-ins, and quite clearly did not even hint at the possibility that the very success of the franchisor's venture could be a shield which would protect him from a finding of violation of law.

In addition, all circuits have held that tying is a *per se* violation whenever the alleged violator has a direct or indirect financial interest in the sale of the tied product. Such an interest exists whenever the violator is the seller, as in this case (lease and license

are sold through wholly-owned subsidiaries of the parent corporation), or where the violator obtains money from the third party vendor.[5]

This entire analysis is destroyed by the Fourth Circuit's decision in this case, especially with respect to claims by third party vendors.[6] Notwithstanding the *per se* treatment accorded the tying violations by all courts which have considered the question, the Fourth Circuit has in this case reintroduced the "rule of reason" approach by relying on "business justification" or the "success formula." In spite of *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 97 S.Ct. 2549 (1977), *no* other court has ever condoned such an approach. The narrow exception is where it would be unduly difficult to use standards and/or specifications (e.g., quality control), but a jury question is always presented. The market analysis approach is based upon the illegality of unreasonably interfering with the market for the second product, not because of some advantage in the price or quality of the tied product but because of the seller's

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[5]See *Diviersified Pkging. Corp. v. Kentucky Fried Chicken Corp.*, 552 F.2d 601 (5th Cir. 1977); *Venzie Corp. v. U.S. Mineral Products Co., Inc.*, 521 F.2d 1309 (3rd Cir. 1975); *Fast Food Fabricators v. McDonald's Corp.*, ____ F. Supp. ____ (N.D. Cal. 1980), 1980-2 T.C. ¶63,552; *Heatransfer Corp. v. Volkswagenwerk, A.G.*, 553, F.2d 964 (4th Cir. 1977), 434 U.S. 1087 (1978).

[6]If a general building contractor were the plaintiff in this case, he would lose under the Fourth Circuit's new rule, because of the claim by McDonald's that its engaging an outside contractor is essential to the success of its franchised system. In this context, it is noteworthy that McDonald's does *not* itself perform the construction work, but has it performed by outsiders.

advantage in the tying market. If this new philosophy is accepted, the market for the tied product will be destroyed.[7] Throughout the trial of this case, McDonald's claimed that the real reason for the sublease tie was that it needed the extra income because its royalty income was inadequate. The success formula here, then, was the success "needed" by the franchisor, *not* the franchisee.

The novelty of this new rule cannot be fully appreciated without comparing it to the rule announced in *United States v. Jerrold Electronics Corporation*, 187 F. Supp. 545 (E.D. Pa. 1960), *aff'd. per curiam*, 365 U.S. 567 (1961). In *Jerrold*, the guidelines which will determine whether there is one product or two are clearly set forth. None of the tests listed therein for determining product unity are here in evidence, nor has that list of tests since been challenged. Of critical note in the current context, however, is the listing in *Jerrold* of those excuses which will permit the otherwise concededly violative practice to go unpunished. Among those excuses is the "failing company doctrine," applicable in that instance, where the seller could not keep his head above water unless he was permitted some leeway to force the purchase of the second product. Left undefined in *Jerrold* was the point at which the failing company doctrine would no longer be availing to the seller who uses it and thereafter achieves some success in the marketplace. Implied within the decision is a finding

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[7]See *Warriner Hermetics, Inc. v. Copeland Refrigeration Corp.*, 463 F.2d 1002 (5th Cir. 1972), *cert. den.* 409 U.S. 1086 (1972); and see *Heatransfer Corp.*, *Venzie Corp.*, and *Fast Food Fabricators, supra.*

that, when the unlawful practice is no longer essential to the seller's survival, it is no longer excused. Clearly, the failing company doctrine has no applicability in this case involving the admitted leader and giant of the fast food franchising business.[8]

While *Principe* retreats from *Chicken Delight* in its position on the so-called "package" theory as being too restrictive, the Fourth Circuit has overlooked *Chicken Delight's* ultimate determination that a disputed issue of fact, concerning what is the public's view of the end product, mandates submission of the issue to the trier fact. McDonald's "need" for this protection must be jury found. While it should almost go without saying, it is apparently necessary to emphasize here that every one of the decisions set out in footnote 4 has required that disputed issues of fact be tried and not, in a jury case, submitted to the court for determination by directed verdict.

The Fourth Circuit has moreover attempted to distinguish *Northern v. McGraw-Edison Company*, 542 F.2d 1336 (8th Cir. 1976), *cert. den.* 429 U.S. 1097, *reh. den.* 430 U.S. 960 (1977), and *Carpa v. Ward Foods, Inc.*, 536 F.2d 39 (5th Cir.1976), for lack of an in-depth analysis of the findings in those cases that the franchise and the lease were separable. It is of particular note in *Carpa* that the claimed aggregation involved a restaurant lease and license. Explicit in the Fourth Circuit's distinction (631 F.2d at 309, n. 6) is a determination that an otherwise illegal tie can be justified with the

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[8]An up-to-date reaffirmation of these same principles appears moreover in the recent decision in *Anderson Foreign Motors v. New England Toyota Distributors*, 1979-2 T.C. ¶62,833 (D. Mass. 1979).

introduction of market research data, which has never before been held and which was, for that reason, not considered in *Northern* or *Carpa*.[9]

Principe attempts to distinguish the decision in *Photovest v. Fotomat Corporation*, 606 F.2d 704 (7th Cir. 1979), *cert. den.*, _ U.S. _, 100 S.Ct. 1278 (1980), where a tying violation was found in the franchisor's requirement that the franchisee lease certain space made available by the franchisor for that purpose. *Principe* ignores the decision in that case upon the distinction that, in *Photovest*, the franchisor "merely leased space" and then subleased it to franchisees, which is precisely what McDonald's does with many of its franchisees, including the Principes, at one of their licensed store operations.

It is of considerable note that *Photovest* was decided by the Seventh Circuit, which encompasses McDonald's home office (in suburban Chicago). In 1980, the Seventh Circuit refused to entertain any doubt on this very violation in *Photovest*, where Fotomat made the identical claim as that made by McDonald's here. Undoubtedly, other cases will be coming up in the Seventh Circuit[10]

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[9]An in-depth analysis of the separability of products, however was indeed set forth in the written opinion of a trial court in *Beefy Trail, Inc. v. Beefy King International, Inc.*, 348 F.Supp. 799 (M.D. Fla. 1972), the rationale of which was adopted and discussed in both *Carpa* and *Northern*.

[10]See *Martino v. McDonald's System, Inc.*, 81 F.R.D. 81 (N.D. Ill. 1979); and see *Marane Incorporated v. McDonald's Corporation and McDonald's Systems, Inc.*, (N.D. Ill.), Case No. 79-C-816, an action now pending in the trial court in Chicago, where plaintiff Marane is presenting the same tying issue.

and a head-on collision of circuits must therefore occur with regard to the identical issue, against the very same defendant.[11]

The reliance in *Principe* on *Ungar v. Dunkin' Donuts of America, Inc.*, 531 F.2d 1211 (3rd Cir.), *cert. den.* 429 U.S. 823, 97 S.Ct. 74 (1976), overlooks the clear decision of the Third Circuit in that case that a coerced purchase of the second product, if proven, establishes a violation when the other relevant tests are met. *Ungar* did not dispense with that proof, nor with those tests, nor with the concept of the violation. The *un*-coerced purchase of numerous items making up the franchise "package," however, is not and never has been a matter of any concern whatsoever to the antitrust laws.[12]

The decision in *Principe* ignores virtually all of the landmark cases in the antitrust field as well as the decision logic expressed in each. It relies however upon a number of decisions which do not apply or which are of questionable precedential value. For example, in relying upon *Kugler v. Aamco Automatic Transmission, Inc.*, 460 F.2d 1214 (8th Cir. 1972), the Fourth Circuit equates

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[11]The same tying issue is again presented in *Kypta v. McDonald's Corp.*, et al., a case presently on appeal to the Fifth Circuit from the Southern District of Florida, where the identical questions of tying violations against McDonald's have been raised. In *Kypta*, the question will of course be governed by the Fifth Circuit's prior decision in *Carpa v. Ward Foods, Inc.*, 536 F.2d 39 (5th Cir. 1976).

[12]In addition, to the extent that there may be any doubt as to what the Third Circuit held in *Ungar*, the doubt was resolved by that court's subsequent decision in *Bogosian v. Gulf Oil Corp.*, 561 F.2d 434 (3rd Cir. 1977), *cert. den.* 434 U.S. 1086 (1978), with which *Principe* is in irreconcilable conflict.

leased premises with mandatory advertising in determining that only a single product exists. The court apparently overlooks, however, the fact that *Kugler* has never been questioned in this case; that the tying of advertising was never raised in this case; and that any attempt to broaden the Eighth Circuit's 1972 decision as to mandatory advertising runs into immediate conflict with that court's later decision in *Northern*, *supra*, which found a violation in the tying of a lease and a license.

Likewise, reliance upon *In Re: 7-Eleven Franchise Litigation*, 1974-2 T.C. ¶75,429 (N.D. Cal. 1974), is misplaced, since that 1974 California trial court decision failed to abide by the 1971 holding of the Ninth Circuit in *Chicken Delight*, *supra*, as to which certiorari was denied in 1972. Until the instant case, no other appeals court has adopted *7-Eleven*.

The Fourth Circuit's statement that, "Franchising has come a long way since the decision in *Chicken Delight*," 631 F.2d at 309, ignores the critical distinctions which have been drawn by a long line of cases, between the distribution of trademarked goods, and the trademarked distribution of non-trademarked goods; see *Warriner Hermetics, Inc. v. Copeland Refrigeration Corporation*, 463 F.2d 1002 (5th Cir. 1972), *cert. den.* 409 U.S. 1086 (1972). Moreover, "how far franchising has come" has never been factually determined, let alone has it been determined factually or legally that

franchising has come so far that it can now be given an industry-wide dispensation from enforcement of the Sherman Act.[13]

In relying upon *Krehl v. Baskin-Robbins Ice Cream Co.*, 78 F.R.D. 108 (C.D. Cal. 1978), *Principe* overlooks the companion decision of a year later in *Krehl v. Baskin-Robbins Ice Cream Co.*, 1979-2 T.C. ¶62,806 (C.D. Cal. 1979), which held that the question of separateness of products was a fact question for the jury.

The extent of the conflict created by *Principe* is complete. Not only is the decision in conflict with the decisions of this Court and every other court of appeals which has considered tying violations, it is in irreconcilable conflict with the prior decisions of the Fourth Circuit, itself. In *Osborn v. Sinclair Refining Co.* 286 F.2d 832 (4th Cir. 1960), the Fourth Circuit, guided by this Court's mandate in *International Salt Co. v. U.S.*, 332 U.S. 392 (1947), determined, 286 F.2d at 838, that the claimed

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[13]In this case, McDonald's insists upon control of the premises, either by owning the site and leasing it to the franchisee, or by leasing it from the owner and subleasing it to the franchisee. Under this total control, McDonald's itself provides for the building to be constructed. That construction however is not performed by McDonald's, but by third parties with McDonald's supervision. It is therefore indefensible not to allow the franchisee to have the construction performed, subject to the same kind of supervision. Note however, the extremely weak and unsupported footnote conclusion in *Principe*, 631 F.2d at 310, n. 7, that McDonald's said that its supervisors would leave the company if they could not continue under the present format. The point is in any event irrelevant, since the "supervisors" would still perform the same function vis-a-vis the outside general contractors, in the manner now being practiced.

benefit to the franchisee of the packaged (i.e., tied) products "does not avoid the stifling effect of the agreement on competition." *Osborn* correctly stated the rules governing tie-in claims handed down since the landmark 1958 decision of *Northern Pacific Railway Co. v. United States*, 356 U.S. 1 (1958), and its progeny, and in no way departed from the *per se* illegality of tying. Moreover, the Fourth Circuit acknowledged in *Osborn*, 286 F.2d at 835, the validity of the results reached in the TBA cases.[14] Those cases, long since litigated to their conclusion and incorporated in the body of caselaw governing illegal tie-in schemes, are now nullified by the essence of *Principe*, as quoted at the beginning of this argument, that the distinction between aggregated components in an otherwise unlawful tie-in scheme will be blurred or ignored if the aggregation is a part of the seller's formula for success. Without doubt, every seller guilty of unlawful tying engaged in the practice because he thought it would help make his business more of a success. If the seller may now determine, by himself, that his "success" depends upon his requiring the purchase of tied products, the effect of all prior caselaw in the field of franchise tying is wiped out, and the likelihood that any seller hereafter will be found in violation of the statute is, as a practical matter, reduced to zero.

Osborn, moreover, was one of the decisions specifically relied upon by the Ninth Circuit in *Chicken Delight*, 448 F.2d at 53, as to which this Court denied

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[14]See, for example, *FTC v. Texaco, Inc.*, 393 U.S. 223, 89 S.Ct. 429 (1968), and cases cited therein, concerning tying of tires, batteries and accessories in gas station franchising.

certiorari. The enormous and unanimous body of caselaw predating *Osborn* and *Chicken Delight*, and relied upon by each of them, is directly and irreconcilably in conflict with *Principe*, which permits a defendant's "formula for success" to be the fulcrum upon which the question of violation will turn. *Principe's* retreat from the decision in *Chicken Delight*, therefore, is a retreat from the body of caselaw which the Fourth Circuit has in the past both relied upon, without exception, and itself created.

More recent than *Osborn* is *Advance Business Systems and Supply Co. v. SCM Corporation*, 415 F.2d 55 (4th Cir. 1969), *cert. den.* 397 U.S. 920, 90 S.Ct. 928 (1970), where the Fourth Circuit's tradition of enforcement continued without change of direction, in reliance upon the precedent both in existence as of *Osborn*, and established since that time. More specifically, *Advance Business Systems* held, 415 F.2d at 60, that "tie-ins can rarely be justified for they 'serve hardly any purpose beyond the suppression of competition.' "

In addition, *Advance Business Systems* specifically analyzed the success of the defendant's scheme, and considered that success as at least some evidence of the coercive force of the seller's unlawful plan. While the Fourth Circuit recognized that a coerced purchase was a necessary pre-requisite, the very "success" of the seller in requiring that almost literally everyone purchase the allegedly tied product lent significant weight to the argument that the purchase was forced and was therefore part of an illegal scheme. The holding in *Principe* exonerates that same seller from a finding of illegality, because of the very same success determined

by the Fourth Circuit to have been proof of guilt in *Advance Business Systems.*

More recently still, in *Phillips v. Crown Central Petroleum Corporation*, 602 F.2d 616 (4th Cir. 1979), *cert. den.* 397 U.S. 920, 90 S.Ct. 928 (1970), the Fourth Circuit reaffirmed its commitment to the now unquestioned principle that there is no excuse or immunity to the seller who coerces the purchase of multiple products. *Phillips* in turn relied upon *Ungar*, 531 F.2d at 1224, which carefully analyzed the two-product offer, and decided, both consistently and correctly, that a finding of violation would turn on the question of coercion of the purchaser to take the forced second product. Absent coercion, the violation fails. The concept of an immunity is specifically nullified if the second product is purchased by force.

Notwithstanding the prophecies of doom made by McDonald's in the trial and appellate courts, there is no question but that McDonald's can continue doing nearly everything that it is now doing, and that it may do so lawfully under the decisions of those other courts with which *Principe* conflicts. The only change required in McDonald's formula for success, to bring it within compliance, is the elimination of the absolute compulsion that McDonald's format be followed without exception. If a prospective franchisee suggests a proposed site which McDonald's finds attractive and in accordance with its standards, and if the franchisee provides for the construction of the building by a general contractor approved by McDonald's no legitimate need of the franchisor to control quality and standardization will go unfulfilled. The franchisor does not "make" either the site or the building, but contracts with others for

each of those elements utilized in its "formula." Since no viable quality control argument was ever suggested, the rule announced by every other court to have addressed the question is that the franchisee must be given the opportunity to himself contract for and provide those elements of the packaged aggregation. If he volunteers to waive that right and purchases the entire package from McDonald's, without having been coerced to do so, the antitrust laws are satisfied.

It is well recognized that the Court will assume jurisdiction where a federal court of appeals has rendered a decision in conflict with the decision of another federal court of appeals on the same matter. See for example *Safeway Stores v. Vance* 355 U.S. 389, 78 S.Ct. 358 (1958), *reh. den.* 356 U.S. 910, 78 S.Ct 667 (1958), where certiorari jurisdiction was taken because of conflict between different courts of appeal.[15]

C. Question of Great National Importance

The Court can judicially note the enormous impact on American life and business created by franchising. Automobiles, petroleum products, hotels, fast food, and many smaller industries have, in the past two generations, made franchising responsible for a significant portion of the nation's gross national product. Franchising touches

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[15]See also *N.L.R.B. v. Metropolitan Life Insurance Company*, 380 U.S. 438, 85 S.Ct. 1061 (1965); *Hawkins v. United States*, 358 U.S. 74, 79 S.Ct. 136 (1958); and *Knetsch v. United States*, 364 U.S. 361, 81 S.Ct. 132 (1960). And see *F.T.C. v. Flotill Products, Inc.*, 389 U.S. 179, 88 S.Ct. 401 (1967); and *Perma Life Mufflers, Inc. v. Intern. Parts Corp.*, 392 U.S. 134, 88 S.Ct. 1981 (1968) (conflict between decisions of courts of appeal "seemed to threaten the effectiveness of the private action as a vital means for enforcing the antitrust policy of the United States," 392 U.S. at 136).

virtually all consumers; there is no populated corner of the nation not touched by the signs of franchising (literal as well as figurative), inducing a purchase through an outlet which may not be known to the consumer, but which is part of a national or regional chain which he recognizes.

Until now, the franchising industry has been restrained under the antitrust laws from requiring additional purchases as a condition to the sale of a desirable and attractive product. *Principe*, however, lifts that restraint, and eliminates — at least in the Fourth Circuit — the body of caselaw which holds tying unlawful. The franchisor is now given free rein to fashion his marketing plan around any aggregation of products which may be commercially attractive and viable, notwithstanding the multiple purchase requirement. By simply making the statement that "success" was his purpose, the franchisor is entitled to summary judgment on any complaint charging that the aggregation is unlawful.

The impact of this new rule upon franchising is enormous and incalculable. Given the substantial portion of American consumerism involved in franchising, the impact of this new rule on the business of the nation is likewise beyond measure. The Chevrolet dealer could now be required to stock Pontiacs. The Texaco distributor could now be required to purchase his tires, batteries, and accessories from his suppliers, with no further obstacle remaining from the TBA cases previously decided.

Moreover, the "aggregation" need not be restricted to the intermediate levels of the supply chain. The purchaser could be required to buy his Chevrolet with all of the "extras" which until now had been traditionally regarded as optional. If selling every Chevrolet with air conditioning and stereo radio is a part of General Motors' formula for success, the requirement of such additional purchases will not be challenged in that court which follows *Principe*. The decision here under review therefore has a profound effect upon the antitrust laws as they affect franchising and, in turn, profoundly affects the business of the nation. The question presented is therefore one of great importance to the developing law of antitrust, and to the business of the nation.

Radical departure from the body of precedent has always been grounds for this Court's intervention through certiorari. In *Eastern Rail. Pres. Conf. v. Noerr Motor Frgt., Inc.*, 365 U.S. 127, 81 S.Ct. 523 (1961), *reh. den.*, 365 U.S. 875, 81 S.Ct. 899 (1961), the Court took jurisdiction upon a finding that the case "presents a new and unusual application of the Sherman Act***" 365 U.S. at 135, 81 S.Ct. at 528.[16]

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[16]And see *Continental Ore Co. v. Union Carbide & Carbon Corp.*, 370 U.S. 690, 82 S.Ct. 1404 (1962); and *Klor's, Inc. v. Broadway-Hale Stores, Inc.*, 359 U.S. 207, 79 S.Ct. 705 (1959) (important questions presented under the antitrust laws found by the Court to mandate its taking jurisdiction). See also *Glus v. Brooklyn Eastern District Terminal*, 359 U.S. 231, 79 S.Ct. 760 (1959), and *Federal Power Com'n v. Tuscarora Indian Nation*, 362 U.S. 99, 80 S.Ct. 543 (1960).

II

WHETHER A CIRCUIT COURT'S REFUSAL TO FOLLOW ITS OWN APPLICABLE RULE REQUIRING A TRIAL DETERMINATION OF CONTESTED FACT ISSUES IS SO CONTRARY TO FUNDAMENTAL LAW AS TO WARRANT ISSUANCE OF CERTIORARI.

Principe stands for two concepts, both of which are completely novel in the law. The first, that a success motive will excuse judicial condemnation, is discussed in the preceding section. Equally novel is the concept that this newly created defense of "success" need not even be proven, and that the court will withhold scrutiny as well as condemnation. In all of the cases cited in the foregoing section it was a foregone conclusion that genuine issues of material fact are routinely submitted to the trier of fact and are not susceptible of directed verdict. The Principes do not here repeat that argument nor those citations, but briefly supplement that argument with reference to a few authorities which, in any case, would ordinarily be considered boilerplate, concerning ordinary trial procedure.

In *Richmond Television Corporation v. United States*, 354 F.2d 410 (4th Cir. 1965), the Fourth Circuit correctly held the trial court should not "***supplant the jury if there is any reason whatsoever for disagreement." The "disagreement" between the parties in this action is reflected in the record of nearly two weeks of trial proceedings. Every material element of a tying violation was virgorously contested. From the record of confrontation between the parties, it could hardly be determined, as a matter of law, that McDonald's is, as

it urges, the benevolent despot. The Fourth Circuit, in finding that McDonald's would not harm its franchisees, not only concluded a finding of fact at the appellate level, it found facts which conflict with the probability of disagreement as to the evidence which was presented. In "finding" not only that McDonald's has a "formula for success," but that the challenged aggregation is an "essential ingredient" to that formula, the Fourth Circuit has departed from its previous decisions which have reserved exclusively to the jury all questions but those on which "reasonable men could not differ." See *Wachovia Bank & Trust Co. v. United States*, 288 F.2d 750, 757 (4th Cir. 1961).

Principe refers, 631 F.2d at 307, to evidence submitted by McDonald's as to the historical necessity for its requiring the purchase of the second product after having established for several years a business which imposed no such requirement. A reading of *Principe* suggests that the "fact" of that historical need was either stipulated or found. It was neither. The trial court correctly informed the jury that the prepared statement as to what Mr. Kroc would say was not an agreed fact, rather that it was agreed that if he were to appear in court, that is what he would say; the trial court left to the jury the question whether such claimed necessity existed. The trial court then took that question from the jury. The decision in *Principe* assumes that the jury found that necessity, which simply did not happen. Moreover, even were one to assume such necessity had been found, it disappeared 20 years ago, when Kroc bought out the McDonald's brothers' remaining interest in 1961 (see discussion, 631 F.2d at 306, n. 5).

Clearly, the "fact" of the historical necessity for McDonald's tie-in practice has never been judicially found. It was *urged* by defendants. The trial court correctly advised the jury that it was a contested issue of fact but then proceeded to take from the jury a determination of that issue.[17]

Finally, *Principe* finds, 631 F.2d 310, 311, that McDonald's "cannot allow its franchisees to lose money," and that McDonald's "promises to make each new McDonald's store successful." For the reasons above stated these are — clearly, simply, and basically — jury questions. However, they have never been passed on by a jury. They are in fact contradicted by competent evidence adduced by the Principes at trial that they were denied the opportunity of developing their own restaurant properties. Under the most fundamental concepts of trial procedure, these factual disputes were for the jury to decide, not the court.

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[17]In addition, *Principe* further relies upon a number of contentions as if they had been established (i.e., stipulated or proven) as the underlying basis for decision that McDonald's "formula for success" legitimized the challenged aggregation. What happened, however, was that the Fourth Circuit simply adopted as proven fact those challenged contentions of McDonald's that it "offers a complete method of doing business"; that the tied items are "intregal components of the business method being franchised"; that this "pervasive franchisor supervision and control benefits the franchisees"; and that McDonald's "will not undercut existing franchisees' businesses" (631 F.2d at 309, 310). These are jury questions; reasonable men could differ.

CONCLUSION

The decision in *Principe* announces a new rule which in effect grants unfettered license to any franchisor who may be sued under a claim of tying violation to (a) cite this case, and (b) submit his affidavit that he has aggregated products because he needs to in his "formula for success." That rule is both new and totally at odds with the rules laid down by every appellate court which has considered the question. The decision below presents a question of great national importance and of the clearest conflict imaginable. It moreover reached its conclusion through a process which radically departs from the accepted and usual course of judicial proceedings.

This court should accordingly take certiorari jurisdiction for a full review of the record and the merits of the decision below, on all issues raised in the appellate court.

Respectfully submitted,

John R. Kelso, and
Harold L. Ward,
Counsel for Petitioners
501 City National Bank Building
Miami, Florida 33130

Harold Brown,
Of Counsel

February 17, 1981

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that three (3) copies of the foregoing Petition, and Appendix, were served this 17th day of February, 1981, upon Alan H. Silberman, Esquire, Sonnenschein, Carlin, Nath & Rosenthal, 8000 Sears Tower, Chicago, Illinois 60606; and Thomas G. Slater, Esquire, Hunton & Williams, 707 East Main Street, P.O. Box 1535, Richmond, Virginia 23212, Counsel for Respondents, by depositing same in a United States mailbox, with first-class postage prepaid.

Harold L. Ward

APPENDIX

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Decision below — *Principe v. McDonald's Corp.*, 631 F.2d 303 (4th Cir. 1980) ..... App. 2

Order denying Petition for Rehearing. App. 25

[631 F.2d 303]*

Frank A. PRINCIPE, Ann Principe and Frankie, Inc,

Appellants,

v.

McDONALD'S CORPORATION, McDonald's System, Inc.
and Franchise Realty Interstate Corporation,

Appellees.

No. 79-1702.

United States Court of Appeals,
Fourth Circuit.

Submitted June 3, 1980.

Decided Sept. 26, 1980.

Fast food franchisee brought antitrust suit against franchisor, alleging that franchisor was guilty of an illegal tying arrangement. The United States District Court for the Eastern District of Virginia, D. Dortch Warriner, J., rendered judgment for the franchisor and franchisee appealed. The Court of Appeals, Harry Phillips, Senior Circuit Judge, sitting by designation, held that the franchisor's requiring its franchisees to operate their franchises in premises leased from the franchisor and requiring franchisees to make a $15,000 security deposit, which did not gather interest, did not amount to an illegal tying arrangement, in that all three items were integral components of the business

*Page numbers from official text are set out in brackets.

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method being franchised and made up the package which made the franchise uniquely attractive to franchisees.

Affirmed.

Monopolies — 17(2.5, 2.6)

Fast food franchisor's requiring its franchisees to operate their franchises in premises leased from franchisor and requiring franchisee to make $15,000 security deposit, which did not gather interest, did not amount to illegal tying arrangement, in that all three items were integral components of business method being franchised and made up package which made franchise uniquely attractive to franchisees. Sherman Anti-Trust Act, §1, 15 U.S.C.A. §1.

Harold L. Ward, Miami, Fla. (Harold Brown, John R. Kelso, Miami, Fla., James G. Harrison, Hopewell, Va., Fowler, White, Burnett, Hurley, Banick & Strickroot, P.A., Miami, Fla., on brief), for appellants.

Earl E. Pollock, Chicago, Ill. (Alan H. Silberman, Louis C. Keiler, Robert T. Joseph, Sonnenschien, Carlin, Nath & Rosenthal, Chicago, Ill., Thomas G. Slater, Jr., Ray V. Hartwell, III, Hunton & Williams, Richmond, Va., Shelby Yastrow, Oak Brook, Ill., on brief), for appellees.

Before WINTER, Circuit Judge, HARRY PHILLIPS, Senior United States Circuit Judge, Sixth Circuit, sitting by designation, and J. DICKSON PHILLIPS, Circuit Judge. [304]

[304]

HARRY PHILLIPS, Senior Circuit Judge.

This appeal presents the question of whether a fast food franchisor that requires its licensees to operate their franchises in premises leased from the franchisor is guilty of an illegal tying arrangement in violation of §1 of the Sherman Act, 15 U.S.C. §1.[1] On the facts of this case, we hold it does not and affirm the directed verdict for the defendants.

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[1]The complaint also alleged that the mandatory franchise lease combination violates §3 of the Clayton Act, 15 U.S.C. §14. The directed verdict for the defendants made it unnecessary for the district court to differentiate between the Sherman Act and Clayton Act tying claims. We note, however, that §3 of the Clayton Act is limited to restraints involving "goods, wares, merchandise, machinery, supplies or other commodities." Because neither the tying (franchise) nor the tied (lease and security deposit) product fits this definition, the defendants were entitled to summary judgment on the Clayton Act tying claims. See *Moore v. Jas H. Matthews & Co.*, 550 F.2d 1207, 1214 (9th Cir 1977). *Cf. Advance Business and Supply Co. v. SCM Corp.*, 415 F.2d 55, 65-66, *cert. denied*, 397 U.S. 920, 90 S.Ct. 928, 25 L.Ed.2d 101 (1970). Section 3 does not apply where the tied product is a service contract.

[304] I

The appellants, Frank A. Principe, Ann Principe and Frankie, Inc., a family owned corporation, are franchisees of McDonald's System, Inc. The Principes acquired their first franchise, a McDonald's hamburger restaurant in Hopewell, Virginia, in 1970. At that time, they executed a twenty year franchise license agreement and a store lease of like duration. In consideration for their rights under these agreements, the Principes paid a $10,000 license fee and a $15,000 security deposit, and agreed to remit 2.2 per cent of their gross receipts as royalties under the franchise agreement and 8.0 per cent as rent under the lease.[2] In 1974, Frank Principe and his son, Raymond, acquired a second franchise in Colonial Heights, Virginia, on similar terms. The Colonial Heights franchise subsequently was transferred to Frankie, Inc., a corporation owned jointly by Frank and Raymond Principe.

The Principes sought to purchase a third franchise in 1976 in Petersburg, Virginia. Robert Beavers, McDonald's regional manager, concluded the plaintiffs lacked sufficient management depth and capabilities to take on a third store without impairing the quality of their existing operations. During the next twenty months, the Principes obtained corporate review and reconsideration of the decision to deny them the franchise. They were notified in May 1978 that the Petersburg franchise was being offered to a new franchisee.

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[2]Since 1970 McDonald's has increased the franchise fee to $12,500, the franchise royalty to three per cent and the rent payment to 8.5 per cent.

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They filed this action a few days later alleging violations of federal and state antitrust and securities laws and state franchising laws. Counts I and II alleged McDonald's violated federal antitrust laws by tying store leases and $15,000 security deposit notes to the franchise rights at the Hopewell and Colonial Heights stores. Count XII alleged McDonald's denied the Principes a third franchise in retaliation for their refusal to follow McDonald's pricing guidelines. The remaining counts, alleging violations of state and federal antitrust and securities laws, as well as Virginia franchising laws, were dismissed prior to trial and are not before us on this appeal.

Following discovery the district court granted summary judgment for McDonald's on the security deposit note tie in claims. District Judge D. Dortch Warriner found the notes represented deposits against loss and do not constitute a product separate from the store leases to which they pertain.

The court directed a verdict for McDonald's on the store lease tie in counts at the close of all the evidence. Relying on the decision of this court in *Phillips v.* [304] *Crown Central Petroleum Corp.*, 602 F.2d 616 (4th Cir.), *cert. denied*, 444 U.S. 1074, 100 S.Ct. 1021, 62 L.Ed.2d 756 (1980), Judge Warriner held the Principes had failed to introduce any evidence of McDonald's pow-[305]er in the tying product market, which he held is the food retailing market. The court held, however, McDonald's sells only one product: the license contract and store lease are component parts of the overall package

[304]

McDonald's offers its prospective franchisees. Accordingly, Judge Warriner held as a matter of law there was no illegal tie in.

[305] II

At the time this suit was filed, McDonald's consisted of at least four separate corporate entities. McDonald's Systems, Inc. controlled franchise rights and licensed franchisees to sell hamburgers under the McDonald's name.[3] Franchise Realty Interstate Corporation (Franchise Realty) acquires real estate, either by purchase or long term lease, builds McDonald's hamburger restaurants, and leases them[4] either to franchisees or to a third corporation, McOpCo. McOpCo, which is not a party to this suit, operates about one-fourth of the McDonald's restaurants in the United States as company stores. Straddling this triad is McDonald's Corporation, the parent, who owns all the stock of the other defendants. Because the various defendants have substantially similar corporate hierarchies and operate in conjunction under the direction and control of the corporate parent, we shall refer to them collectively as McDonald's unless the context requires otherwise.

McDonald's is not primarily a fast food retailer. While it does operate over a thousand stores itself, the vast majority of the stores in its system are operated by franchisees. Nor does McDonald's sell equipment or supplies to its licensees. Instead its primary business is developing and collecting royalties from limited menu

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[3]McDonald's System, Inc. subsequently was merged into McDonald's Corporation, the parent, and no longer exists as a separate entity.

[4]The McDonald's system of restaurants included some 4465 stores in 1978, 99 percent of which were owned by Franchise Realty. *See Martino v. McDonald's System, Inc.*, 81 F.R.D. 81, 84 (N.D.Ill.1979).

[305]
fast food restaurants operated by independent business people.

McDonald's develops new restaurants according to master plans that originate at the regional level and must be approved by upper management. Regional administrative staffs meet at least annually to consider new areas into which McDonald's can expand. Once the decision is made to expand into a particular geographic area, specialists begin to search for appropriate restaurant sites.

McDonald's uses demographic data generated by the most recent census and its own research in evaluating potential sites. McDonald's attempts to analyze and predict demographic trends in the geographic area. This process serves a two fold purpose: (1) by analyzing the demographic profile of a given market area, McDonald's hopes to determine whether the residents are likely to buy fast food in sufficient quantities to justify locating a restaurant there; (2) by anticipating future growth, McDonald's seeks to plan its expansion to maximize the number of viable McDonald's restaurants within a given geographic area. Based on a comparison of data for various available sites, the regional staffs select what they believe is the best site in each geographic area. Occasionally no available site suits McDonald's requirements and expansion must be postponed. [306]

The regional staffs compile master plans for expansion once particular sites are selected. These generally extend three years into the future and are broken down by site and month. Each proposed new restaurant is assigned projected dates for acquisition

of the land, ground breaking and opening. These dates vary from location to location because of differences in restaurant size, zoning and special permit requirements and various other factors. The completed master plans must be approved first by regional management and later by corporate management.

As part of the planning process, McDonald's decides what type of store to build on each site and where to locate it on the land. Differences in lot size and shape necessitate adjustments in store and parking lot configurations. Projected market size dictates dining room size. Land elevation, sign restrictions, store visibility and local set back requirements control restaurant placement.

After the specifics of each proposed new restaurant are approved, McDonald's decides whether the store will be company operated or franchised. If the decision is to franchise the store McDonald's begins the process of locating a franchisee. This involves offering the store either to an existing franchisee or to an applicant on the franchise waiting list. Applicants need not live near the store in order to be offered the franchise, and they need not accept the first franchise they are offered. The Principes lived in Kenosha, Wisconsin, and rejected eleven separate McDonald's restaurants before accepting their first franchise in Hopewell, Virginia. McDonald's often does not know who will operate a franchised store until it is nearly completed because a new restaurant may be offered to and rejected by several different applicants.

Meanwhile, Franchise Realty acquires the land, either by purchase or long term lease and constructs

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the store. Acquisition and development costs averaged over $450,000 per store in 1978. All McDonald's restaurants bear the same distinctive features with a few exceptions due to architectural restrictions: the golden arches motif, the brick and glass construction and the distinctive roofline. According to the defendants, these features identify the stores as a McDonald's even where zoning restrictions preclude other advertising or signs.

As constructed, McDonald's restaurants are finished shells; they contain no kitchen or dining room equipment. Furnishing store equipment is the responsibility of the operator, whether a franchisee or McOpCo. McDonald's does provide specifications such equipment must meet, but does not sell the equipment itself.

Having acquired the land, begun construction of the store and selected an operator, McDonald's enters into two contracts with the franchisee.[5] Under the first,

[5]According to McDonald's, the two contract procedure is the product of the original agreement between Ray A. Kroc, the founder of McDonald's Corporation, and Richard and Maurice McDonald, who conceived the McDonald's speedy service system and licensed it to Mr. Kroc. His original agreement with the McDonald brothers prohibited Mr. Kroc from making any unilateral changes in the text of the McDonald's trademark licensing agreement under which he was issuing franchises. That licensing agreement provided McDonald's Corporation would collect 1.9 per cent of franchisees' gross sales and pay the McDonald brothers 0.5 per cent of gross sales as a trademark royalty. When McDonald's Corporation began to develop restaurants and offer them as part of the franchise package, it had to use separate franchise and lease agreements. Although the restriction on changing the terms of the franchise agreement was removed when the corporation bought the McDonald brothers' remaining interest in 1961, separate

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the franchise agreement, McDonald's grants the franchisee the rights to use McDonald's food preparation system and to sell food products under the McDonald's name. The franchisee pays a $12,500 franchise fee and agrees to remit three per cent of his gross sales as a royalty in return. Under the [307] second contract, the lease, McDonald's grants the franchisee the right to use the particular store premises to which his franchise pertains. In return, the franchisee pays a $15,000 refundable security deposit (as evidence of which he receives a twenty year non-negotiable non-interest bearing note) and agrees to pay eight and one half per cent of his gross sales as rent. These payments under the franchise and lease agreements are McDonald's only sources of income from its franchised restaurants. The franchisee also assumes responsibility under the lease for building maintenance, improvements, property taxes and other costs associated with the premises. Both the franchise agreement and the lease generally have twenty year durations, both provide that termination of one terminates the other, and neither is available separately.

(Footnote Continued)

franchise and lease agreements were used until 1976 when they were integrated into a single document. Because Hopewell, Colonial Heights and most of the other McDonald's stores franchised before 1976 are still operated under interdependent franchise and lease agreements, we shall disregard McDonald's current practice for purposes of this appeal.

[307] III

The Principes argue McDonald's is selling not one but three distinct products, the franchise, the lease and the security deposit note. The alleged antitrust violation stems from the fact that a prospective franchisee must buy all three in order to obtain the franchise.

As evidence that this is an illegal tying arrangement, the Principes point to the unfavorable terms on which franchisees are required to lease their stores. Not only are franchisees denied the opportunity to build equity and depreciate their property, but they must maintain the building, pay for improvements and taxes, and remit 8.5 per cent of their gross sales as rents. In 1978 the gross sales of the Hopewell store generated about $52,000 in rent. That figure nearly equalled Franchise Realty's original cost for the site and corresponds to more than a fourth of the original cost of the entire Hopewell restaurant complex. At that rate of return, the Principes argue, Franchise Realty will have recouped its entire investment in four years and the remainder of the lease payments will be pure profit. The Principes contend that the fact the store rents are so high proves that McDonald's cannot sell the leaseholds on their own merits.

Nor has McDonald'a shown any need to forbid its licensees to own their own stores, the Principes say. Appellants contend that McDonald's is the only fast food franchisor that requires its licensees not only to pay royalties but to lease their stores from the franchisor. *But see Krehl v. Baskin-Robbins Ice Cream Co.*, 78 F.R.D. 108 (C.D.Cal. 1978). Before 1959 McDonald's itself permitted franchisees to own their own stores. McDonald's

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could maintain its desired level of uniformity by requiring franchisees to locate and construct stores according to company specifications. The Company could even provide planning and design assistance as it apparently does in connection with food purchasing and restaurant management. The Principes argue McDonald's has not shown that the success of its business or the integrity of its trademarks depends on company ownership of all store premises.

A separate tied product is the note that evidences the lessee's $15,000 security deposit, according to the appellants. The Principes argue the security deposit really is a mandatory contribution to McDonald's working capital, not security against damage to the store or breach of the lease contract. By tying the purchase of these $15,000 twenty year non-negotiable non-interest bearing notes to that of the franchise, McDonald's allegedly has generated a capital fund that totalled over $45 million in 1978. It is argued that no one would purchase such notes on their own merits. The Principes assert that only by requiring franchisees to purchase the notes as a condition of obtaining a franchise has McDonald's been able to sell them at all.

McDonald's responds that it is not in the business of licensing use of its name, improving real estate for lease or selling long term notes. Its only business is developing a system of hamburger restaurants and collecting royalties from their sales. The allegedly tied products are but parts of the overall bundle of franchise benefits and obligations. According to McDonald's, the ap-[308]pellants are asking the court to invalidate the way McDonald's does business and to require it to

adopt [308]the licensing procedures of its less successful competitors. Federal antitrust laws do not compel such a result, McDonald's contends.

"There is, at the outset of every tie-in case, including the familiar cases involving physical goods, the problem of determining whether two separate products are in fact involved." *Fortner Enterprises, Inc. v. United States Steel Corp.*, 394 U.S. 495, 507, 89 S.Ct. 1252, 1260, 22 L.Ed.2d 495 (1969) (*Fortner I*). Because we agree with McDonald's that the lease, note and license are not separate products but component parts of the overall franchise package, we hold on the facts of this case there was no illegal tie in. Accordingly, we affirm the summary judgment and directed verdict for McDonald's on the tying claims.

As support for their position, the Principes rely primarily on the decision of the Ninth Circuit in *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43 (9th Cir. 1971), *cert. denied*, 405 U.S. 955, 92 S.Ct. 1172, 31 L.Ed.2d 232 (1972), one of the first cases to address the problem of franchise tie-ins. Chicken Delight was what McDonald's characterizes as a "rent a name" franchisor: it licensed franchisees to sell chicken under the Chicken Delight name but did not own store premises or fixtures. The company did not even charge franchise fees or royalties. Instead, it required its franchisees to purchase a specified number of cookers and fryers and to purchase certain packaging supplies and mixes exclusively from Chicken Delight. These supplies were priced higher than comparable goods of competing sellers. 448 F.2d at 46-47. A class composed of franchisees challenged the tying arrangement as a violation of the Sherman Act. The district court held for the franchisees and Chicken Delight appealed.

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In addressing Chicken Delight's argument that the allegedly tied products all were essential components of the franchise system, the Ninth Circuit looked to the "function of the aggregation." 448 F.2d at 48. Viewing the essence of a Chicken Delight franchise as the franchisor's trademark, the court sought to determine whether requiring franchisees to purchase common supplies from Chicken Delight was necessary to ensure that their operations lived up to the quality standards the trademark represented. Judged by this standard, the aggregation was found to consist of separate products:

> This being so, it is apparent that the goodwill of the Chicken Delight trademark does not attach to the multitude of separate articles used in the operation of the licensed system or in the production of its end product. It is not what is used, but how it is used and what results that have given the system and its end product their entitlement to trademark protection. It is to the system and the end product that the public looks with the confidence that estabished goodwill has created. 448 F.2d at 49.

In the court's view, Chicken Delight had attempted "to extend trade-mark protection to common articles (which the public does not and has no reason to connect with the trade-mark)", *Id.*, a classic kind of illegal tying arrangement. *Cf. United States v. Paramount Pictures*, 334 U.S. 131, 158, 68 S.Ct. 915, 929, 92 L.Ed. 1260 (1948).

The Principes urge this court to apply the *Chicken Delight* reasoning to invalidate the McDonald's franchise lease note aggregation. They urge that McDonald's can

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protect the integrity of its trademarks by specifying how its franchisees shall operate, where they may locate their restaurants and what types of buildings they may erect. Customers do not and have no reason to connect the building's owner with the McDonald's operation conducted therein. Since company ownership of store premises is not an essential element of the trademark's goodwill, the Principes argue, the franchise, lease and note are separable [309] products tied together in violation of the antitrust laws.[6]

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[6]Such a result would not be entirely unprecedented. In *Photovest Corporation v. Fotomat Corporation*, 606 F.2d 704, 724-725 (9th Cir. 1979), *cert. denied*, 445 U.S. 917, 100 S.Ct. 1278, 63 L.Ed.2d 601 (1980), the Seventh Circuit held Fotomat's practice of requiring its franchisees to lease kiosks from the frachisor is an illegal tying arrangement. In *Northern v. McGraw-Edison Company*, 542 F.2d 1336 (8th Cir. 1976), *cert. denied*, 429 U.S. 1097, 97 S.Ct. 1115, 51 L.Ed.2d 544 (1977), the Eighth Circuit found a tying violation where a franchisor licensed its trademarks to dealer agents who, in turn, assembled complete dry cleaning operations and leased them as "going businesses" to franchisees. Similarly, in *Carpa, Inc. v. Ward Foods, Inc.*, 536 F.2d 39 (5th Cir. 1976), the court found an illegal tie in where a seafood restaurant franchisee was required to lease a completed restaurant from his franchisor.

However, none of these decisions dealt in any detail with the issue before this court: whether a franchise package granting the right to conduct a business in a specific company owned store can be separated into tying and tied products. Both *Northern* and *Capra, Inc.* were concerned primarily with equipment and supplies tie ins; store leases were only the vehicles by which the illegally tied packages were conveyed. While *Photovest* is closer to the present case, it is distinguished by the fact that Fotomat merely leased space in shopping center parking lots, installed prefabricated

(Footnote Continued)

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In *Phillips v. Crown Central Petroleum Corporation, supra*, 602 F.2d at 627, this court spoke of the "emerging law of tie ins in franchise settings". We noted that "the very essence of a franchise is the purchase of several related products in a single competitively attractive package." *Id.* at 628, see also *Ungar v. Dunkin' Donuts of America, Inc.*, 531 F.2d 1211, 1224 (3d Cir.), *cert. denied*, 429 U.S. 823, 97 S.Ct. 74, 50 L.Ed.2d 84 (1976). Franchising has come a long way since the decision in *Chicken Delight*.

Without disagreeing with the result in *Chicken Delight*, we conclude that the court's emphasis in that case upon the trademark as the essence of a franchise is too restrictive. Far from merely licensing franchisees to sell products under its trade name, a modern franchisor such as McDonald's offers its franchisees a complete method of doing business. It takes people from all walks of life, sends them to its management school, and teaches them a variety of skills ranging from hamburger grilling to financial planning. It installs them in stores whose market has been researched and whose location has been selected by experts to maximize sales potential. It inspects every facet of every store several times a year and consults with each franchisee about his operations's strengths and weaknesses. Its regime pervades all facets of the business, from the design of the menu board to the amount of catsup on the

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(Footnote Continued)

kiosks, and subleased to franchisees. There was no argument that Fotomat had greater expertise than its franchisees, conducted elaborate market research, or invested substantial sums of money. The Seventh Circuit did not elaborate its reasons for finding the franchise and lease separable. Because none of these cases dealt with the two product question in depth, we do not find them controlling as precedents.

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hamburgers, nothing is left to chance. This pervasive franchisor supervision and control benefits the franchisee in turn. His business is identified with a network of stores whose very uniformity and predictability attracts customers. In short, the modern franchisee pays not only for the right to use a trademark but for the right to become a part of a system whose business methods virtually guarantee his success. It is often unrealistic to view a franchise agreement as little more than a trademark license.

Given the realities of modern franchising, we think the proper inquiry is not whether the allegedly tied products are associated in the public mind with the franchisor's trademark, but whether they are integral components of the business method being franchised. Where the challenged aggregation is an essential ingredient of the franchised system's formula for success, there is but a single product and no tie in exists as a matter of law.

Applying this standard to the present case, we hold the lease is not separable from the McDonald's franchise to which it pertains. McDonald's practice of developing a system of company owned restaurants operated by franchisees has substantial advan-[310]tages, both for the company and for franchisees. It is part of what makes a McDonald's franchise uniquely attractive to franchisees.

First, because it approaches the problem of restaurant site selection systematically, McDonald's is able to obtain better sites than franchisees could select. Armed with its demographic information, guided by its staff of experts and unencumbered by preferences of

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individual franchisees, McDonald's can wield its economic might to acquire sites where new restaurants will prosper without undercutting existing franchisees' business or limiting future expansion. Individual franchisees are unlikely to possess analytical expertise, undertake elaborate market research or approach the problem of site selection from an area wide point of view.[7] Individual franchisees benefit from the McDonald's approach because their stores are located in areas McDonald's has determined will produce substantial fast food business and on sites where that business is most likely to be diverted to their stores. Because McDonald's purposefully locates new stores where they will not undercut existing franchisees' business, McDonald's franchisees do not have to compete with each other, a substantial advantage in the highly competitive fast food industry.

Second, McDonald's policy of owning all of its own restaurants assures that the stores remain part of the McDonald's system. McDonald's franchise arrangements are not static: franchisees retire or die; occasionally they do not live up to their franchise obligation and must be replaced; even if no such contingency intervenes, the agreements normally expire by their own terms after twenty years. If franchisees owned their own stores, any of these events could disrupt McDonald's business and have negative effect on the system's goodwill. Buildings whose architecture identified them as former McDonald's stores would sit idle or be used for other

[7]Nor would requiring corporate approval of franchisees' site selection decisions be a satisfactory alternative. McDonald's regional manager testified that the Company's planning and acquisition experts are unlikely to stay with McDonald's if their roles become purely advisory.

purposes. Replacement franchisees would have to acquire new and perhaps less desirable sites, a much more difficult and expensive process after the surrounding business area has matured. By owning its own stores, McDonald's assures its continued presence on the site, maintains the store's patronage even during management changes and avoids the negative publicity of having former McDonald's stores used for other purposes. By preserving the goodwill of the system in established markets, company store ownership produces attendant benefits for franchisees.

Third, because McDonald's acquires the sites and builds the stores itself, it can select franchisees based on their management potential rather than their real estate expertise or wealth. Ability to emphasize management skills is important to McDonald's because it has built its reputation largely on the consistent quality of its operations rather than on the merits of its hamburgers. A store's quality is largely a function of its management. McDonald's policy of owning its own stores reduces a franchisee's initial investment, thereby broadening the applicant base and opening the door to persons who otherwise could not afford a McDonald's franchise.[8] Accordingly, McDonald's is able to select franchisees primarily on the basis of their willingness to work for the success of their operations. Their ability to begin operating a McDonald's restaurant without having to search for a site, negotiate for the land, borrow hundreds of thousands of dollars and construct a store building is of substantial value to franchisees.

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[8]The record establishes that the Principes could not have obtained financing to construct their first restaurant themselves.

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Finally, because both McDonald's and the franchisee have a substantial financial stake in the success of the restaurant, their relationship becomes a sort of partnership that might be impossible under other cir-[311]cumstances. McDonald's spends close to half a million dollars on each new store it establishes. Each franchisee invests over $100,000 to make the store operational. Neither can afford to ignore the other's problems, complaints or ideas. Because its investment is on the line, the Company cannot allow its franchisees to lose money. This being so, McDonald's works with its franchisees to build their business, occasionally financing improvements at favorable rates or even accepting reduced royalty payments in order to provide franchisees more working capital.

All of these factors contribute significantly to the overall success of the McDonald's system. The formula that produced systemwide success, the formula that promises to make each new McDonald's store successful, that formula is what McDonald's sells its franchisees. To characterize the franchise as an unnecessary aggregation of separate products tied to the McDonald's name is to miss the point entirely. Among would be franchisees, the McDonald's name has come to stand for the formula, including all that it entails. We decline to find that it is an illegal tie in. *Cf. Kugler v. Aamco Automatic Transmissions, Inc.*, 460 F.2d 1214, 1215-16 (8th Cir. 1972) (franchise and mandatory advertising constitute a single product); *In re 7-Eleven Franchise Litigation*, 1974-2 Trade Cases ¶75,429 (N.D.Cal.) (convenience store franchise package is not separable into tied and tying products).

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We have examined the Principes' other contentions and do not believe they warrant extended discussion. The security deposit note was just that: evidence of a security deposit on a lease which we have held was a legitimate part of the franchise package. The evidentiary rulings of the district court would not require reversal even if erroneous. The jury's unsolicited comment that the Principes had been wronged was expressly qualified by their statement that price fixing was not the reason. The district court correctly determined that the note did not affect the integrity of the jury verdict.

Affirmed.

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 79-1702

Frank A. Principe, et al,

Appellants,

versus

McDonald's Corporation, etc., et al,

Appellees.

ORDER

Upon consideration of the appellants' petition for rehearing and suggestion for rehearing en banc, and no judge having requested a poll on the suggestion for rehearing en banc,

It is ADJUDGED and ORDERED that the petition for rehearing is denied.

Entered at the direction of Judge Winter for a panel consisting of Judge Winter, Judge Harry Phillips (S.C.J. — 6th Circuit), and Judge Phillips.

For the Court,

/s/ William K. Slate, II
CLERK

UNITED STATES DISTRICT COURT

FOR THE

EASTERN DISTRICT OF VIRGINIA

CIVIL ACTION FILE NO. 78-0601-R

FILED
JUDGMENT
JUL 30 1979

CLERK, U. S. DISTRICT COURT
RICHMOND, VA.

FRANK A. PRINCIPE, et al.

vs.

McDONALD'S CORPORATION, etc., et al.

This action come on for trial before the Court and a jury, Honorable D. DORTCH WARRINER, United States District Judge, presiding, and the issues having been duly tried and the jury having duly rendered its verdict,

It is Ordered and Adjudged that the Plaintiffs take nothing; and that Defendants, McDONALD'S CORPORATION, McDONALD'S SYSTEM, INC., and FRANCHISE REALTY INTERSTATE CORPORATION, recover of the Plaintiffs, FRANK A. PRINCIPE, ANN PRINCIPE, and FRANKIE, INC., their costs of action.

Dated at Richmond, Virginia, this 30th day of July, 1979.

W. FARLEY POWERS, JR.
Clerk of Court
By: /s/Linda K. McDonald
Linda K. McDonald
Deputy Clerk